INDEX

	Page
Opinions below	1
Jurisdiction	2
Questions presented	2
Statute involved	2
Statement	3
Argument	6
Conclusion	17
Appendix	18

CITATIONS

Cases:	
Central Funding Corporation, In re, 75 F. 2d 256	11
Clinton Trust Co. v. *John H. Elliott Leather Co.*, 132 F. 2d 299	11
Country Life Apartments, Inc. v. *Buckley*, 145 F. 2d 935	11, 13
Fidelity Assurance Ass'n v. *Sims*, 318 U. S. 608	10, 12
Isaacs v. *Hobbs Tie & Timber Co.*, 282 U. S. 734	16
Mokava Corporation v. *Dolan*, 147 F. 2d 340	8
Patent Cereals v. *Flynn*, decided June 7, 1945	13
Security-First Nat. Bank v. *Rindge Land and Navigation Co.*, 85 F. 2d 557, certiorari denied, 299 U. S. 613	8
Standard Gas & Electric Co. v. *Deep Rock Oil Co.*, 117 F. 2d 615, certiorari denied, 313 U. S. 564	8
V. Loewer's Gambrinus Brewery Co., In re, 141 F. 2d 747	14
Young v. *Higbee Company*, 324 U. S. 204	9
Statute:	
Bankruptcy Act:	
Section 56 (b)	16
57 (e)	16
57 (h)	16
70 (a)	16
77B (b) (9)	11
116 (3)	14
203	9, 18
208	9
212	8, 18
216 (10)	10, 13, 18
236	13, 19
Miscellaneous:	
Hearings on H. R. 6439, reintroduced and reported as H. R. 8046, House Committee on the Judiciary, 75th Cong., 1st Sess.	9

In the Supreme Court of the United States

OCTOBER TERM, 1945

NOS. 164 AND 165

LORRAINE CASTLE APARTMENTS BUILDING CORPORATION, INC., ET AL., PETITIONERS

v.

JUSTIN MACKIEWICH ET AL., AND THE SECURITIES AND EXCHANGE COMMISSION

ANGELO CASTELLANI ET AL., PETITIONERS

v.

JAMES W. MCNICHOLS, TRUSTEE, AND THE SECURITIES AND EXCHANGE COMMISSION AND WILLIAM BART

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court of the United States for the Northern District of Illinois, Eastern Division (R. 446–451) is reported in 53 F.

Supp. 994. The opinion of the Circuit Court of Appeals for the Seventh Circuit (R. 495–502) is reported in 149 F. 2d 55.

JURISDICTION

The judgments of the circuit court of appeals were entered on May 4, 1945 (R. 503–504). The petition for writs of certiorari was filed on June 25, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether, in reorganization proceedings under Chapter X of the Bankruptcy Act, the district court properly granted full participation and voting rights to bonds purchased during the pendency of the proceedings, where there was no showing that the bonds were purchased for any motive other than profitable speculation, and there was no finding of fraud, breach of fiduciary relationship, or access to inside information by the purchasers.

2. Whether a district court, in a Chapter X proceeding, has the power to approve a plan of reorganization which provides for the sale of all of the debtor's property to outside interests at not less than a fair upset price.

STATUTE INVOLVED

The relevant provisions of the Bankruptcy Act are set forth in the Appendix, *infra*, pp. 18–20.

STATEMENT

The debtor, Lorraine Castle Apartments Building, Inc., owns and operates a small apartment building in Chicago and has outstanding $72,500 principal amount of first mortgage bonds secured by a trust deed covering the property, dated March 17, 1928 (R. 2–3, 35). All of the stock of the debtor corporation is owned by Angelo Castellani and Margaret Castellani, petitioners, and, until the appointment of the trustee, Angelo Castellani managed the property of the debtor (R. 4, 142).

Organized as an Illinois corporation in 1928, the debtor initially issued $100,000 principal amount of its first mortgage bonds, of which $85,900 were outstanding on May 1, 1935, the maturity date. A reorganization effected under Section 77B of the Bankruptcy Act at that time resulted in a plan whereby the maturity was extended seven years to May 1, 1942, interest was waived during the first year of the extended period and fixed thereafter at a reduced rate of 3% per annum until maturity, and the stock of the debtor was unaffected. (R. 21.)

In view of its inability to pay the $72,500 of bonds outstanding at the extended maturity date, the debtor, on April 30, 1942, filed a petition for reorganization under Chapter X of the Bankruptcy Act (R. 2–6). On May 5, 1942, the judge approved the petition as filed in good faith and left the debtor in possession of its property (R.

11) until July 20, 1943, when the judge appointed a trustee (R. 92). On July 22, 1943, the district judge requested the Securities and Exchange Commission to file its notice of appearance (R. 102–103), pursuant to Section 208 of the Bankruptcy Act (11 U. S. C. 608), and the Commission became a party to the proceedings.

On August 12, 1942, the debtor filed a plan of reorganization pursuant to which bondholders were to be paid 70% of the amount of their bonds in full settlement of their claim (R. 21–24). The plan was found by a special master to be inadequate in a report (R. 24–32) in which he indicated that at least 85% could be realized by sale of the property (R. 30). Thereafter, certain persons, apparently acting in part in concert (R. 56–61), acquired $52,000 in principal amount of the outstanding bonds for which they paid prices ranging from 70 to 90 cents on the dollar (R. 49, 38, 39); one William Bart, paying 90 cents on the dollar (R. 47, 264–269) became the owner of these bonds, and was thereafter granted leave to intervene (R. 47, 50, 51). None of the individuals who acquired the bonds was ever an officer or director of the debtor or connected with the indenture trustee and none of them had access to inside information (R. 161, 162). The district court affirmed the special master's finding that none of them occupied a fiduciary relationship and that no fraud had been practiced by them in acquiring the bonds (R. 64–65, 160, 449).

On July 20, 1943, the court ordered that the debtor be removed from possession of the property, appointed James W. McNichols trustee, and directed that he prepare a plan of reorganization embracing the sale of the property if fair and feasible and submit it to the special master (R. 92).

On August 31, 1943, the trustee filed a plan of reorganization which provided that the debtor's property be publicly offered for sale at an upset price of $75,000, that the proceeds of such sale, together with cash on hand after payment of expenses, be used to pay in full the claims of bondholders for principal and interest, and that the balance, if any, be paid to stockholders. This plan also provided that in the event of a failure to realize the upset price, a corporation should be formed to operate the property and own it free and clear of the mortgage; all the stock of such corporation would then be issued ratably to the bondholders. (R. 104–113.) The upset price in the trustee's plan was based upon the appraisal dated August 20, 1943, by Paul A. Hazard (R. 114–125). Subsequently the trustee received an offer from one Frank Heller to pay $75,000 for the property; this offer was accompanied by a deposit of $7,500 (R. 377, 388–389).

On September 15, 1943, the debtor submitted another plan (R. 138–141) under which 20% of the face amount of the bonds would be paid immediately and the rest in five years; the stock of

the debtor would be left unaffected. The special master found this plan unfair and not feasible (R. 162), but found the trustee's plan fair and feasible (R. 163). The district court approved the report of the special master (R. 446–451). It issued an order, on February 10, 1944, denying a petition (R. 452–456) to limit the participation of holders of bonds purchased while the proceedings were pending (R. 451), and, on February 21, 1944, entered an order approving the trustee's plan of reorganization (R. 457–460). On appeals from both orders (R. 461, 477),[1] the circuit court of appeals affirmed (R. 503, 504).

ARGUMENT

1. Contrary to petitioners' assertion (Pet. 8, 9), the character of those who purchased bonds while the Chapter X proceedings were pending was fully canvassed by the special master and, as the court below held (R. 499–500), no answer to the petition to limit the claims or hearing thereon was required. The petition was filed after the issue had already been before the special master, and his report that there was "no attempt * * * to perpetrate a fraud upon this Court" (R. 64), that there was no proof adduced to show that the purchasers "induced the bondholders to part with their bonds upon any false representations" (R.

[1] The appeal from the order dated February 10, 1944, was docketed in the court below as No. 8591; that from the order of February 21, 1944, was docketed as No. 8597.

160), and that these purchasers were entitled to participate fully, as provided in the trustee's plan (R. 158),[2] because there was no "privity" between them and the debtor (R. 161), was approved by the district court (R. 449). The evidence shows, and it is not denied by petitioners, that none of the purchasers was a fiduciary, dealt with fiduciaries, had access to inside information, or committed fraud in the conduct of their purchase transactions.

Consequently, it is clear that on a record which is devoid of any foundation for an equitable exception, the rule that holders of securities purchased prior to or during the pendency of reorganization proceedings are entitled, regardless of the prices at which the bonds were purchased, to participate on a parity with those persons who are original holders was properly invoked by the

[2] The objections of the Castellanis to the trustee's plan, filed September 15, 1943, recited *inter alia* (R. 143):

> Said speculators, holding said bonds in the aggregate face amount of Fifty-two Thousand Five Hundred Dollars ($52,500.00) are not entitled to have their claims allowed on a parity with other bondholders, but their claims should be limited to the amount paid for such bonds, being approximately Thirty-eight Thousand Dollars ($38,000.00). Such bondholders should be separately classified for the further reason that they are not entitled to vote on any plan.

Both before and after the filing of the objections to the trustee's plan, the question of limiting claims permeated the record and was the subject both of evidence and considerable colloquy (R. 217–312; 326–398).

court below. *Mokava Corporation* v. *Dolan,* 147 F. 2d 340 (C. C. A. 2); *Security-First Nat. Bank* v. *Rindge Land and Navigation Co.,* 85 F. 2d 557, 561, 563 (C. C. A. 9), certiorari denied, 299 U. S. 613; *Standard Gas & Electric Co.* v. *Deep Rock Oil Co.,* 117 F. 2d 615, 619 (C. C. A. 10), certiorari denied, 313 U. S. 564.

Section 212 of the Bankruptcy Act (Appendix, *infra,* p. 18), the so-called "scrutiny clause" of Chapter X, which provides that the court may limit to cost, claims or stock acquired in contemplation of or in the course of Chapter X proceedings by agents, attorneys, indenture trustees or committees is, as the court below held (R. 498), not applicable to third parties, to strangers to the proceedings, or to anyone who is under no fiduciary obligation to the corporate creditors or stockholders. Indeed, the imposition of any such limitation under the circumstances of this case would be against public policy in that it would "impair the sales value of securities" and "encourage the debtor to delay the plan for rehabilitation in the hope that he will be able to settle the claims against him at less than a fair amount" (R. 499).

Petitioners state that the speculative purchases of bonds during the proceedings were designed "for the purpose of preventing a reorganization" and "thwarting the Act and forcing liquidation" (Pet. 3, 4, 10). But the record contains no

evidence of any purpose on the part of those who purchased bonds of the debtor during the proceedings other than profitable speculation. They did nothing to prevent the debtor from putting through a plan providing for the continued operation of the debtor. On the contrary, it was the district judge and the trustee who were responsible for the submission of a plan providing for the sale of the property (R. 92, 104). Since there was no showing that the bonds in question were purchased for any motive other than profitable speculation, it would have been improper for the court to have disqualified the bonds from voting on the plan. And for reasons already stated, there was no basis in the record for limiting to cost, claims arising from the bonds.[3]

2. The circuit court of appeals properly held that the district court had the power, in this

[3] In the lower court and in their petition, the petitioners have not distinguished between limitation to cost and disqualification of voting rights—two separate problems. Cf. Sections 203 and 212 (Appendix, *infra*, p. 18). The purpose for which the bonds were purchased bears only on the question whether the bonds should be disqualified from voting, not on whether they should be limited to cost. See Section 203; Hearings on H. R. 6439, reintroduced and reported as H. R. 8046, before the House Committee on the Judiciary, 75th Cong., 1st Sess., pp. 180–182; *Young* v. *Higbee Company*, 324 U. S. 204, 211, note 10. Even when the vote of a claim is disqualified, the holder of the claim, in the absence of fraud, breach of fiduciary duty, or access to inside information, is entitled to participate on a parity with the holders of claims of the same class in whatever plan is confirmed.

Chapter X proceeding, to approve a plan providing for the sale of all of the debtor's property at not less than a fair upset price, and this decision, contrary to petitioners' allegation (Pet. 4, 13–14), does not conflict with *Fidelity Assurance Ass'n* v. *Sims*, 318 U. S. 608. Petitioners argue, in effect, that in order for a plan to be effectuated as a plan of reorganization under Chapter X of the Bankruptcy Act, it must contemplate the continued participation of some class of the debtor's securities in the operation of the debtor or a successor corporation as a going concern. But a plan providing for the sale of the debtor's principal assets and the distribution of the proceeds thereof together with the distribution of other assets, such as cash, among security holders and other claimants (R. 132–133) is expressly provided for by Section 216 (10) of the Act (Appendix, *infra*, pp. 18–19). Section 216 provides, in part, as follows:

> A plan of reorganization under this chapter—
>
> * * * * *
>
> (10) shall provide adequate means for the execution of the plan, which may include: the retention by the debtor of all or any part of its property; the sale or transfer of all or any part of its property to one or more other corporations theretofore organized or thereafter to be organized; the merger or consolidation of the debtor with one or more other corporations; the sale of

> all or any part of its property, either subject to or free from any lien, at not less than a fair upset price and the distribution of all or any assets, or the proceeds derived from the sale thereof, among those having an interest therein;

If a proposed plan of reorganization for a debtor which provides for "the sale of all * * * of its property * * * at not less than a fair upset price and the distribution of * * * the proceeds derived from the sale thereof, among those having an interest therein," may be characterized as a plan of liquidation, such a plan is nevertheless expressly authorized by the statute. In *Country Life Apartments, Inc.* v. *Buckley,* 145 F. 2d 935, 938, the Second Circuit adopted the same construction as that of the court below in the instant case. No other circuit has taken a contrary view. And even under the narrower provisions of former Section 77 B (b) (9),[4] a plan looking to the ultimate piecemeal liquidation of the debtor was upheld as a plan of reorganization. *In re Central Funding Corporation,* 75 F. 2d 256, 259 (C. C. A. 2). See also *Clinton Trust Co.* v. *John H. Elliott Leather Co.,* 132 F. 2d 299, 304 (C. C. A. 2).

---

[4] Section 77B (b) provided in part:

> A plan of reorganization within the meaning of this section * * * (9) shall provide adequate means for the execution of the plan, which may include * * * the distribution of assets among creditors or any class thereof * * *

Fidelity Assurance Ass'n v. *Sims,* 318 U. S. 608, is not authority for the proposition that a Chapter X plan must provide for the continued operation of the debtor or a successor corporation as a going concern. The *Sims* case stands only for the proposition that a petition instituting proceedings under Chapter X must be dismissed for failure to meet the statutory requirement that a petition must be filed in good faith (Section 141, 11 U. S. C. 541) where it appears at the inception of the proceedings that the only possible accomplishment of the proceedings would be piecemeal liquidation as in an ordinary bankruptcy liquidation of a debtor.

In the present case, the petition was filed by the debtor in April 1942, was duly approved as properly filed in good faith, and no appeal was taken from the district court's findings. The debtor filed an original plan and subsequently an amended plan. It was not until almost a year and a half after the institution of the proceedings that the court appointed a trustee and directed him to file a plan providing for the sale of the property and the distribution of the proceeds. The court below properly stated that the only question involved in the *Sims* case was whether the petition was lacking in good faith and declared the holding of that case to be that the petition was not filed in good faith where "at the inception of the proceedings, it was obvious that

the only possible accomplishment would be piecemeal liquidation as in ordinary bankruptcy" (R. 500–501). Accord: *Country Life Apartments, Inc.* v. *Buckley,* 145 F. 2d 935, 938 (C. C. A. 2); *Patent Cereals* v. *Flynn,* decided June 7, 1945 (C. C. A. 2).

Where a sale plan is not the only type of plan which could be formulated, but is determined by the court to be fair, equitable, and feasible, and preferable to others submitted, it is clear from the express language of the statute that such a plan is permissible under Section 216 (10) of Chapter X.[5] Inexorable and inevitable piecemeal liquidation plainly foreseeable at the outset, which was the debtor's situation confronting the court in the *Sims* case, is quite different from the instant case. Here there were presented at the outset various possibilities as to plans of reorganization, and the particular plan involving a sale of the entire assets at not less than a fair upset price was selected by the court from these various possibilities.

[5] As the below court stated (R. 501–502), Section 236 of the Act (Appendix, *infra*, pp. 19–20) is applicable only where a plan of reorganization *within the meaning of Section 216* cannot be effectuated because no such plan is proposed, or a proposed plan is not approved by the judge, or an approved plan is not accepted, or confirmation is refused, or a confirmed plan is not consummated. In other words, the judge must resort to Section 236 where those having an interest in the debtor cannot achieve the cooperation necessary to effectuate a fair, equitable, and feasible plan within the scope of Section 216.

The construction of Section 216 (10) adopted by the court below is consistent with the flexibility of remedies inherent in the reorganization court as a court of equity.[6] The existence of the possibility of a plan of sale under Section 216 (10) is important to prevent debtors from abusing their right to file petitions under Chapter X in circumstances where there is no reason for a court to find at the outset a lack of good faith. In this case, the debtor had procured in 1935 a seven-year extension of the debt and a reduction of the interest rate in proceedings under Section 77B. The debtor's original purpose in filing the Chapter X petition was merely to get a further extension. When it was pointed out that the bondholders, many of them of advanced age, had waited long enough for payment (R. 29), the debtor filed a plan providing for the payment of 70% of the face amount of the bonds in full settlement of the bondholders' claims. After the special master stated that he could not approve the payment of less than 85% of the face amount, the debtor offered to pay 80% of the face amount. Finally, after the proceedings had been pending

[6] The Congressional intent to give the reorganization court broad powers to protect the interests of security holders appears also from Section 116 (3) (11 U. S. C. 516 (3)). To meet the situations of great urgency, that Section gives the court power to authorize the trustee to sell the property of the debtor, upon cause being shown, even without a plan being filed or an appraisal being made. *In re V. Loewer's Gambrinus Brewery Co.*, 141 F. 2d 747, 749 (C. C. A. 2).

for almost eighteen months and the trustee had proposed a plan which would result in the bondholders being paid 100% of their claim, the debtor's best offer was the immediate payment of approximately 20% of the principal with a five-year extension of the balance, a plan which the district court found unfair and not feasible.[7]

Under the circumstances, approval of the trustee's plan was in the interest of the requirements of fairness and equity. Certainly the alternatives afforded by Section 236 were undesirable. Dismissal of the proceedings would have been grossly inequitable to the bondholders who have had to wait nine years without payment. They would then have been relegated to their remedy of foreclosure with its inherent delay and expense after already having incurred the delay and expense of Chapter X proceedings which were instituted by the debtor. The other alternative was an adjudication of bankruptcy. And in such case it is by no means clear that the bankruptcy court would have jurisdiction over the assets or that the bond-

[7] In their petition (pp. 4, 9), petitioners raise the question whether it was error for the district court to refuse to submit the debtor's proposal to the security holders. Since it is clear that the proposal was unfair in requiring bondholders to extend the maturity of their bonds without compensation, and was not feasible because the financial condition of the debtor was such that another reorganization might well have been necessary (R. 448, 502), the district court was obviously correct in refusing to submit the proposal.

holders could participate in the proceedings. See Sections 56 (b), 57 (e), 57 (h) and 70 (a) (11 U. S. C. 92 (b), 93 (e), 93 (h), and 110 (a). For the normal rule in bankruptcy is that a bankruptcy court has control over properties which are security for obligations of a bankrupt only to the extent necessary to protect the rights of other security holders who may have an interest in the security after the secured creditors are satisfied. *Isaacs* v. *Hobbs Tie & Timber Co.*, 282 U. S. 734, 738.[8] But even if liquidation in straight bankruptcy were legally permissible, such a liquidation is by no means the same as a sale pursuant to Section 216 (10) under a plan. A plan of reorganization must provide that sale of the property shall be at not less than a fair upset price. A liquidation in bankruptcy may or may not be pursuant to a sale at an upset price. Furthermore, under Chapter X there is always available the alternative of substituting a plan providing for the operation of the property by a reorganized company if no bid equal to the upset price is received. The consequent greater independence of a trustee under Chapter X is apt to bring

[8] In the present case, with the possible exception of a current tax claim, there are no claims against the debtor, other than the secured bonds (R. 131). Consequently, it seems unlikely that the bankruptcy court would have any interest in the sale of the property unless there was a showing of a substantial equity which might be lost by foreclosure. And such a showing does not seem probable.

larger proceeds than a sale in bankruptcy or foreclosure which is made at whatever price the assets will bring.*

Thus, the lower court's construction of Section 216 (10) is not only in accordance with the plain meaning of the words used therein but also is consistent with the requirements of fairness and equity.

CONCLUSION

The decision of the court below is correct and there is no conflict of decisions. Consequently, the petition for writs of certiorari should be denied.

Respectfully submitted. HAROLD JUDSON,

Acting Solicitor General.

ROGER S. FOSTER,
Solicitor,
Securities and Exchange Commission.

JULY 1945.

* Somewhat the same advantages may perhaps be attained by a court in straight bankruptcy. Thus, if no adequate bid is received in a bankruptcy sale, the court might refuse the bid and dismiss the proceedings in order to permit new proceedings under Chapter X to be commenced. However, there is no need for such a cumbersome procedure where the company is already under Chapter X.